DOW THEORY LETTERS INC.

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THE PICTURE: I will start this report with a news clip which offers the incredible picture of the Secretary of the Treasury of the United States touting the public on the stock market. Furthermore, Mr. Connally is making an unqualified prediction regarding the Dow ("We'll break 1,000 this year without any question..."), a procedure no ethical analyst in the business would even attempt. So I ask myself, what can you do with an Administration like this one? Are men without principles fated to continue to hold the power? I wonder?

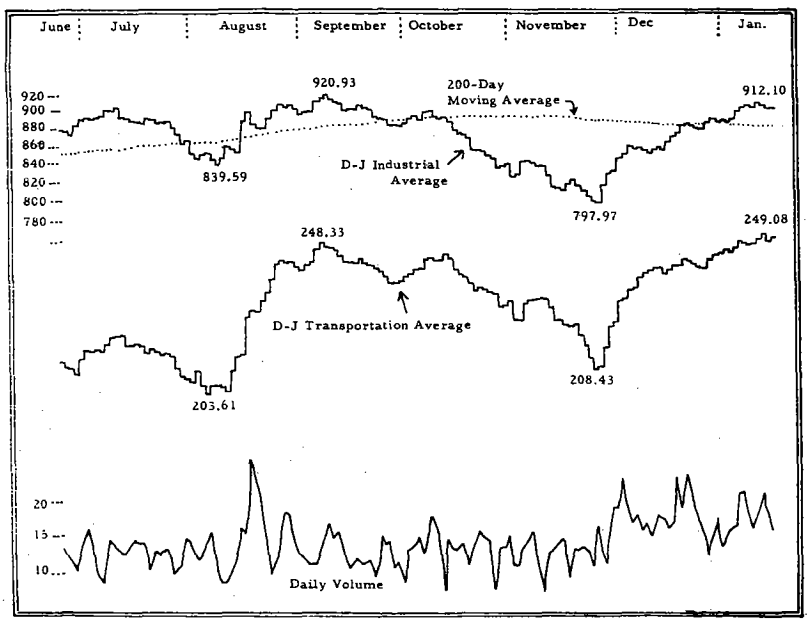
Meanwhile, I thought the week's most significant news story appeared in the Wall Street Journal (back page) of January 11. I have been saying all year that Europe is running into trouble (see clip from the Jan. 11 WSJ), and the trouble cannot be blamed on the recent monetary realignments. As economist Eliot Janeway recently stated, with business as poor as it is in Europe, they need devaluations, not revaluations. And as 1972 progresses, I feel we are going to hear more and more about Europe's business problems.

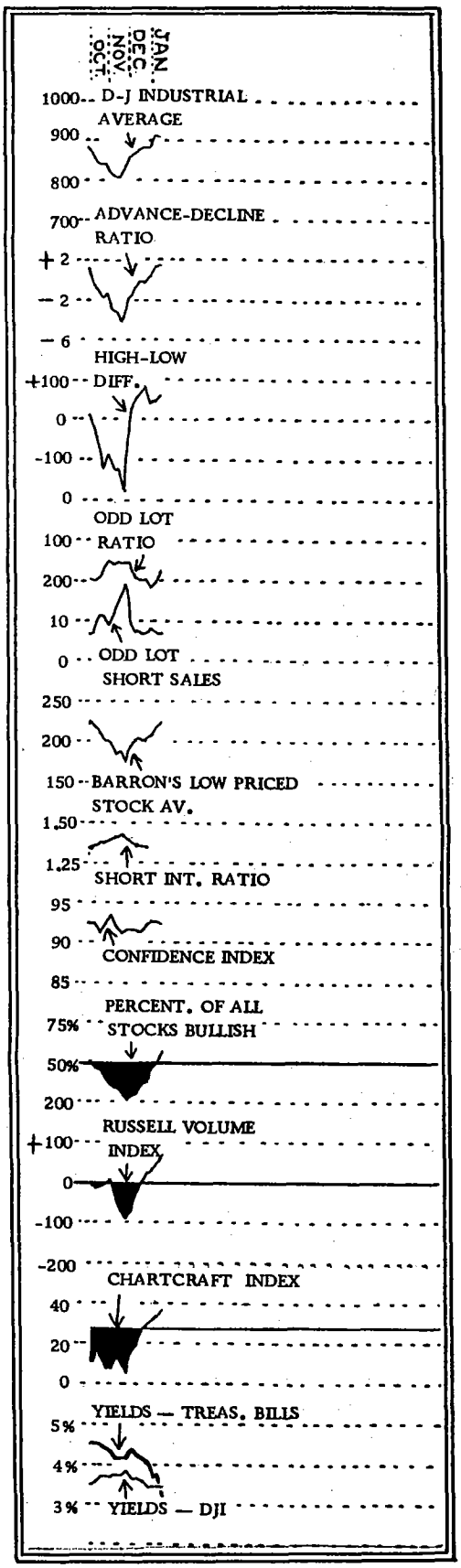
In Britain, capital spending is decreasing and unemployment is at the one million mark. In France (which has been enjoying good business) new orders are dropping off and here too the capital goods industries are sagging. Germany is running into severe trouble with its exports turning down for the first time since World War II. The German steel industry is slumping and Volkswagen closed down for a week in an attempt to pare inventories. Italy is in a recession with consumers cutting back on buying and construction

Stocks To Top 1,000 In '72, Connally Says

WASHINGTON (AP) — Treasury Secretary John B. Connally predicts the stock market will reach a record high this year "without any question."

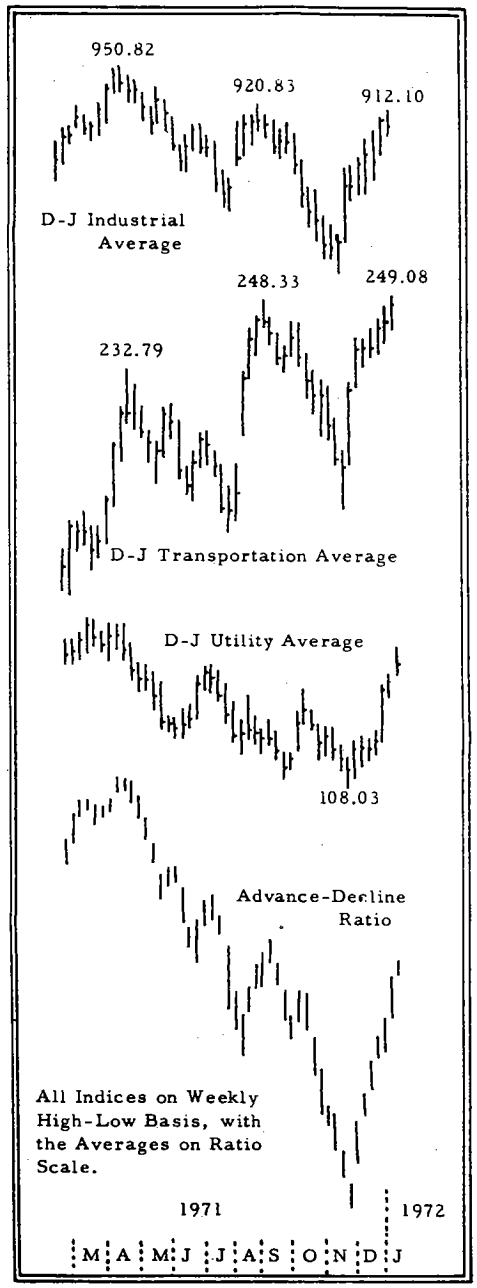
Questioned by reporters Saturday night aboard Air Force One, Connally said the economy will be excellent in 1972. Referring to the Dow-Jones index of industrial stock prices, he said, "I think we'll break 1,000 this year without any question, maybe 1,100." The average stood at 908 Friday. It crept above 995 in 1966.





way down. Finally, Belgium and Holland are both finding business on the slowdown path. All of which provides a strange background for recently re-valued European currencies. In other words, not only are these nations faced with recession but they are faced with increasing difficulties in attempting to export to the U.S. The result will be price cuts and narrowing profits for European corporations.

Europe's business slump is worsening, economic statistics indicate, with unemployment and prices rising and new orders flat or lower. Even a previously strong capital investment outlook is weakening in the downtrend, which had been partly obscured by euphoria over the monetary settlement.



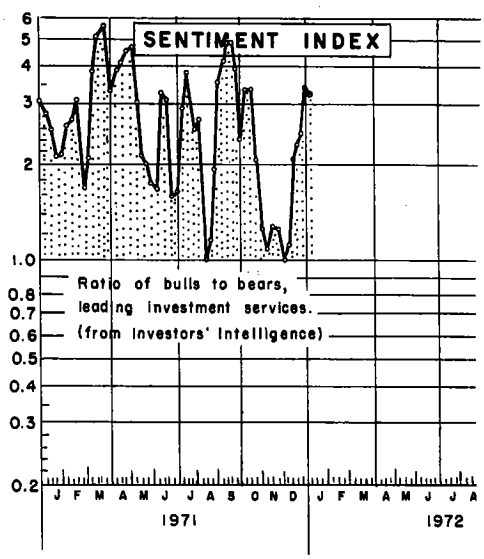
Perhaps in the two general items above, we can see the background pattern for the stock market during 1972. On one side we have the U.S. Administration, its spokesmen and its agencies, pulling out all the plugs, "jawboning", manipulating, producing their "miracle a month" in an astounding attempt to keep this economy "hyped up" at least until the fall, 1972, elections.

On the other side of the ledger we have the primary bear trend, steadfastly resisting the Administration's machinations, absorbing hundreds of millions of shares of stock all under the 1966 peak of 995.15, acting as a brake in the face of the most rampant propaganda campaign to come out of Washington in years. And overseas, where reality seems less strained, the bear's claws are already showing in a gathering European recession, a recession which will probably assume world-wide proportions before 1972 is out.

Meanwhile, Wall Street and the market letter writers have been trying to position themselves on the "right side" of the situation. Note on the accompanying chart (from Merrill Analysis, Box 228, Chappaqua, N.Y. 10514) that the advisory services are now heavily on the bull side with the latest figure showing the bulls outnumbering the bears by better than 3 to 1. Of course, this is a negative reading since the majority of professionals on Wall Street are rarely correct.

Writing about the Dow Theory is particularly difficult and always will be for one fundamental reason. People are ruled basically by the emotions of greed and fear (and sometimes love), not principles. Dow's Theory works on certain immutable principles, and one of them (by far the least accepted) is that just as night follows day, primary bear markets follow primary bull markets. Since a primary bull market saw its top in February, 1966, Dow's Theory states that we will travel through a full primary bear market before the next primary bull market begins. Now this is a principle based on past experience and past evidence. It is based on the same laws which state that nature must ultimately come into balance, that excesses are always adjusted for, that a period of violence is followed by a period of peace, that after the calm comes the storm.

President Nixon does not understand economic principles, but he does understand public psychology. He knows that when he makes money more available, when he boosts defense spending, when he talks about "a very good year", people are apt to feel better. But the President does not understand that everything has its price, and that when you tamper with principles you are going to get reactions which you may not want. For instance, when you put "the squeeze" on Europe and Japan in order to bail out the U.S., the economies of the overseas nations will be hurt, they will import less, and U.S. exports drop off. Thus, just the effect you want (improved U.S. trade balances) may be destroyed, and a world recession may be spurred on.



The President wants the best of both worlds, the vote-getting appeal of ever-increasing pay raises and the inflation-halting appeal of Phase II. So why not produce an "unworkable" Phase II, a vehicle which pretends to stop inflation but one which at the same time allows it. And that is exactly what we have, and it's a question of whether the public knows about it or cares about it by election time, 1972.

The public's capacity of euphoria is almost unlimited. The Vietnam War appears to be winding down, inflation may not be "too bad", unemployment

may not be getting any worse, the monetary crisis may have been "solved", the sun still shines and the Chinese don't hate us. Why worry? Besides, what did all the worrying of the late-1960's, the student riots, the strikes, the marches actually accomplish? This week's Life (Jan. 14) has an article on "Party-Time Tubs" or large community swimming tubs (a la Roman style) in your living rooms, and another article on "When Do We Have the Right to Die?" which deals with the question of whether people should be kept alive against their wishes. I thought the two articles in the same issue said something about our times.

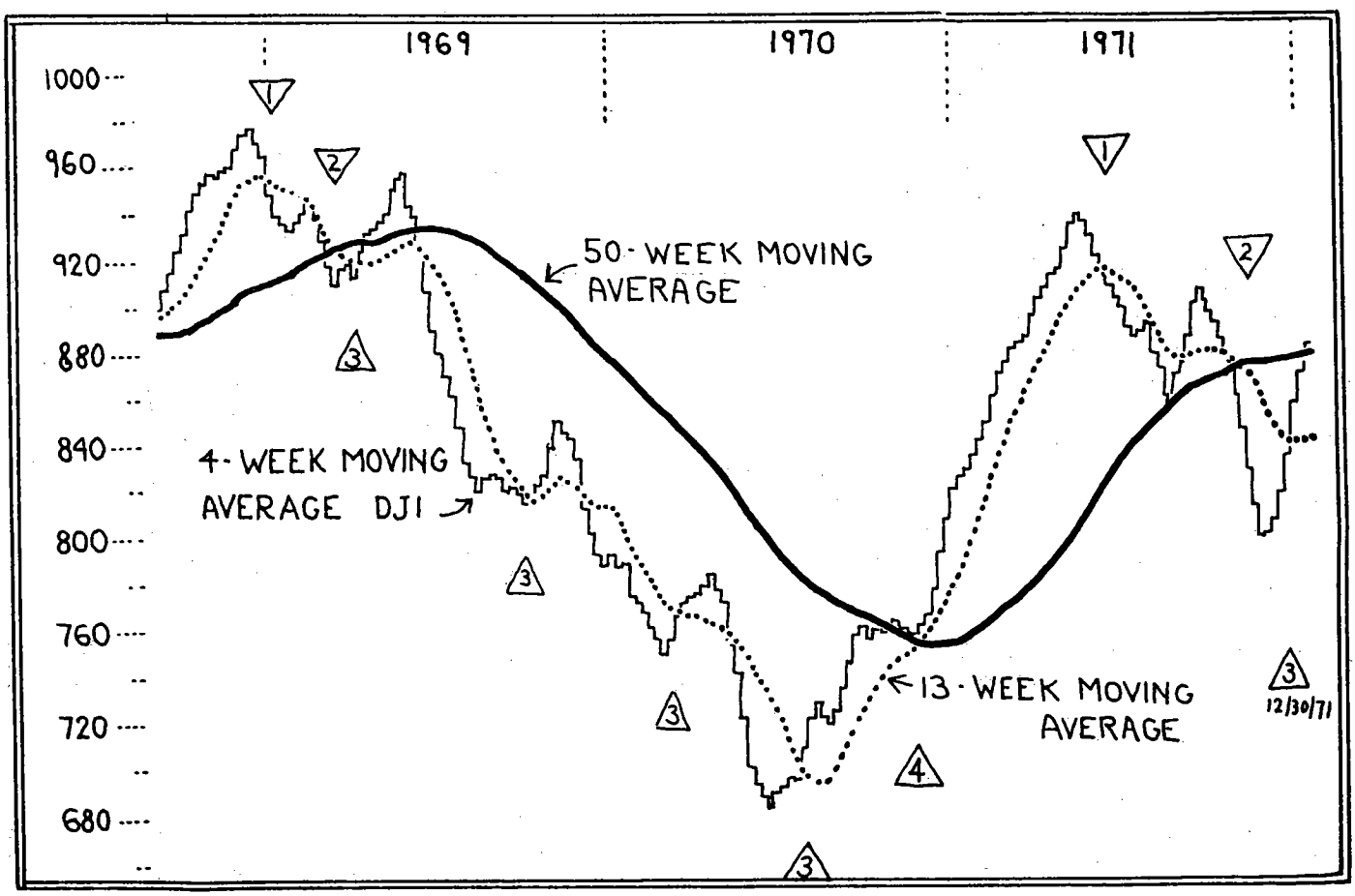
Now, to get to Wall Street, a most interesting development may be taking place. Turning to the page 1 chart, note that the Transportation Average on January 12 closed at a new recovery high of 249.08. This bettered the September 7 peak of 248.33. But (so far) the Industrials could register no better than 912.10 on January 11, and this is well below the previous September peak of 920.92. Thus, a most important non-confirmation may be taking place.

Actually, the importance of what has been happening can be seen in better perspective on the page 2 weekly chart. Here we see a series of non-confirmations with the Transports touching successive highs at 232.79, 248.33 and 1972's 249.08. Against that we see the series of descending lows on Industrials, 950.82 in April, 1971, 920.83 in September, 1971, and 912.10 in January, 1972. From the standpoint of Dow's Theory (non-confirmations), the situation is highly dangerous.

It has been a long time since we have had such a flagrant and long-term series of non-confirmations on the part of the Averages. A failure by Industrials to better 912.10 and a subsequent downturn (particularly in view of the extremely heavy volume which accompanied the non-confirmation) could mark major trouble for Wall Street in 1972.

MOVING AVERAGES: In Letter 512 I presented, for the first time, my study of three moving averages of the D-J Industrials. Although the 200-day moving average of the Dow has appeared (page 1) in these reports ever since the first issue, the three-moving averages study presents a new perspective.

Basically, the study depends on the movements of the DJI which is an average of 30 of the largest investment-grade industrial equities in the nation. The theory is that whatever affects these 30 giants will, in time, affect almost every other stock in the country. Furthermore, these 30 stocks tend to attract investment type money, informed money, and this is the reason they are watched so closely. Nobody claims that the DJI is an average which is representative of the "entire" market. In fact, most of today's divergence studies are based on the tendency of the DJI to move either faster or slower than some of the broader and more representative indicators and averages.



The three moving averages used on the accompanying chart (page 3) are the 50-week MA (approximately one year), the 13-week MA (approximately one quarter) and the 4-week MA (approximately one month). The 50-week MA may be termed the very long-term indicator of the direction of investment money. The 13-week MA may be called the intermediate term indicator of investment money, and the 4-week MA may be labeled the short-term indicator of investment-grade money.

A preliminary bullish signal is given when the4-week MA rises above the 13-week MA (this is marked 3 on the chart). A major bull signal is given when the 13-week MA moves above the 50-week MA (this is marked 4 on the chart). These bullish signals are treated most gingerly, however, during primary bear markets.

A preliminary bearish signal comes when the 4-week MA drops below the 13-week MA (this is marked 1 on the chart) and a long-term bear signal is provided when the 13-week MA plunges below the 50-week MA (this is marked 2 on the chart). Bearish signals receive most credence when they occur within the context of a primary bear market.

Note that the most recent signal was a preliminary bullish signal given on December 30, when the 4-week MA climbed above the 13-week MA. At present the 13-week MA is at 852, and the 50-week MA is at 888, so that it would take considerably more time and continued strength for a number 4 (long-term) bullish signal to be registered. Note also that following bear signal 1 and bear signal 2 of early 1969, a series of number 3 bullish signals were given, but each of these was wiped out as the 4-week moving average turned down and plunged below the 13-week moving average again. Therefore, "playing" each of the number 3 signals would have resulted in a series of costly "whipsaws", and this is the reason I stated that 3 and 4 bull signals should be treated with great care during primary bear markets.

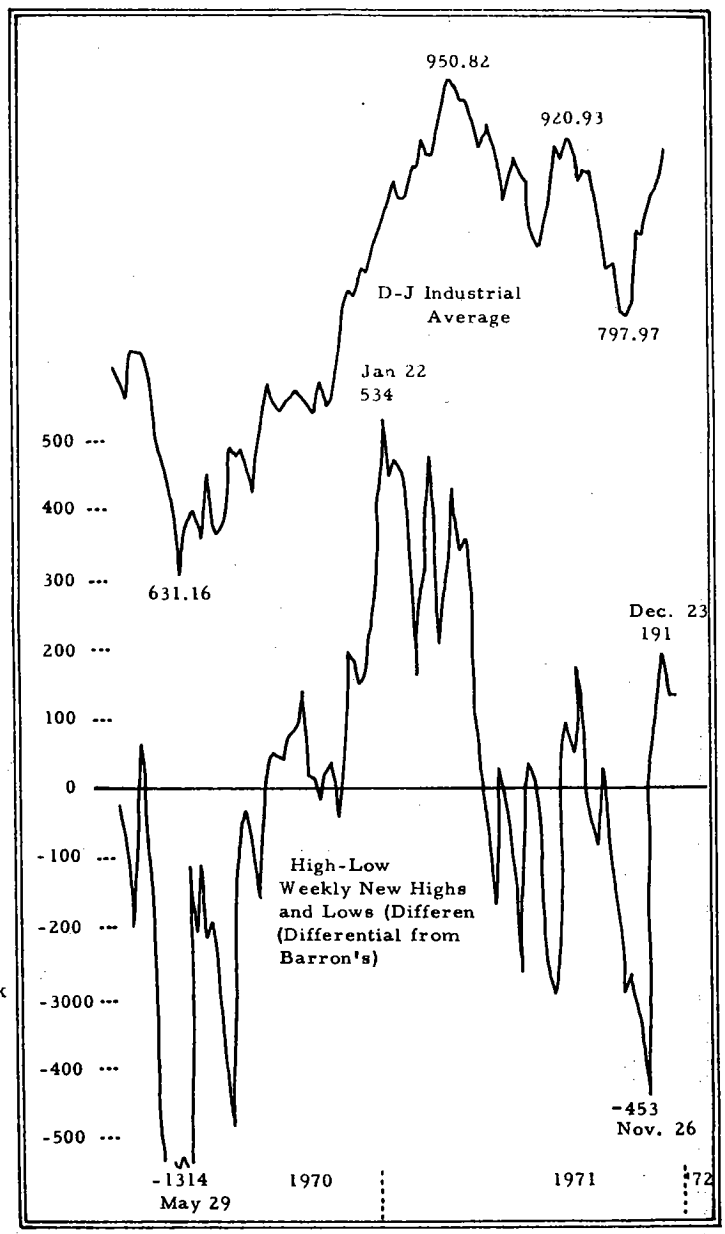
Note that following the number 2 long-term bear signal of early 1969, the 13-week MA refused again to cross above the 50-week MA until the entire 1969-70 decline was over. It was the bearish relationship between the two longer-term MA's which kept the investor safely out of the 1969-70 collapse.

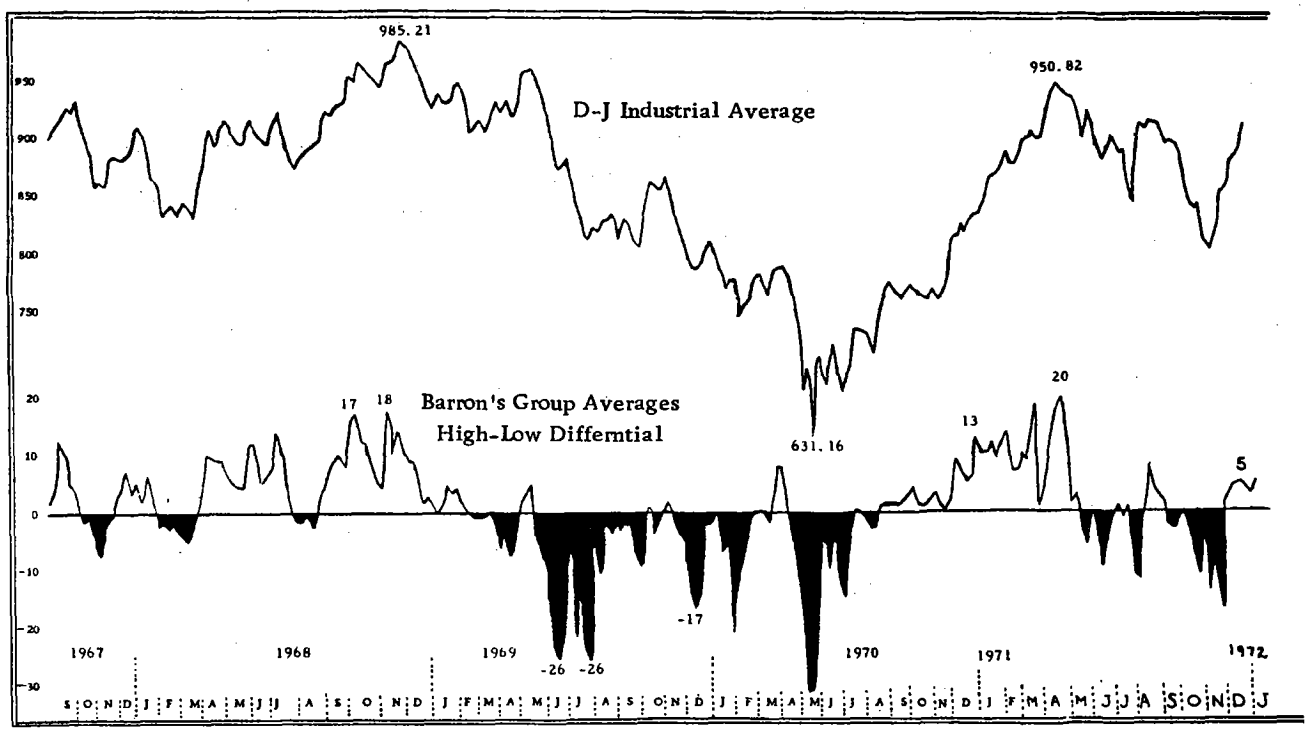
Today, the same relationship exists between the 13-week MA and the 50-week MA with the 13-week holding well below the 50-week despite the violent rally of the DJI and its short-term 4-week MA. Personally, I doubt that we will get a number 4 signal in the weeks and months ahead, but if we do I will immediately report it in these Letters. So far, however, the relationship of the three MA's looks little different than they did during early 1969. The main difference is the more violent movement of the 4-week MA, a situation largely brought on by Mr. Nixon's market-stimulating activities and the euphoria engendered by the monetary agreements of late-1971.

NEW HIGHS AND LOWS: One of the strange factors about the rally since the November 23 low (Dow was at 797.97) is the lack of new highs. This is true both from the standpoint of individual stocks and stock groups, and I am including two charts to illustrate this phenomenon.

The first chart shows the weekly new high-new low differential with figures taken from Barron's each week. For instance, on the week ending January 7, 1972, there were 144 new highs and 15 new lows, which provides a differential figure of plus 129. This figure is then entered on the chart with the DJI closing for the week.

Starting with the climatic 1970 crash figure of minus 1314 (week ending May 29), we see the steady rise in the high-low differentials to the January 22, 1971, peak of 534. Interestingly enough, the advance-decline ratio continued to rise after January, topping out in late-April. Despite this, the weekly high-low index proved to have given an early warning signal and on April 28, the Dow Industrials topped out at 950.82. The Dow then embarked on a long, deceptive decline which terminated on November 23 at 797.97.





Now the most recent history is again quite interesting. From the minus 453 (see chart) on the high-low differential recorded on the week ending November 26, the market started up again. But what surprised me was the decided sluggishness in the high-lows. The peak on the differential figures occurred on the week ending December 23 at 191 (see chart), a week which saw the Dow close at 881. The following week saw the Dow up 9 points at 890, but the differential dropped to 130. Again, with the advance-decline rising (as it did in early 1971), and with the Dow closing out the week of January 7, 1972, at 910 (up 20 points for the week), the high-low differential dropped to 129. On the week ending January 14, with the Dow virtually unchanged, the high-low differential registered 175, still below the December peak of 191. Thus, the level of the high-low differential is, I feel, sub-standard, in view of the fact that the Dow is in the 890-910 area. And more important, the high-low differential has been losing strength ever since the week ending December 23. This is hardly the formula for a booming market into first-quarter 1972.

Now turning to another study which I keep (see Letter 504), this is the high-low differential of the 34 groups which appear in the "Market Laboratory" pages of Barron's (the gold group is deleted, since its movements tend to be counter to the rest of the market). Here again, the evidence (so far) is most interesting. The peak of the group high-low differential was recorded on the week ending December 23 at plus 5. The following week (with the Dow up 9 points) the group high-low dropped to plus 4. On the week ending January 7, 1972, (Dow up 20 points) the group high-low differential sank to plus 3. The latest week (Jan. 14) saw a still-sluggish plus 5.

Clearly, the sluggishness in group high-lows is confirming the high-low differentials in individual stocks. It is, as I said in the last Letter, characteristic of primary bear markets to produce average highs for the year in January or in the first quarter (as happened in 1971). Then, the market is apt to enter a long slide, recording its lows towards the end of the year. Such a process hardly seems possible in the face of today's almost universal optimism regarding the Administration, the economy and the stock market. But the high-low studies indicate that the "unexpected" could well occur.

NO SOLUTION: During 1972 it is going to dawn on an increasing number of people that the monetary "triumphs" of 1971 provided no solutions. As stated in the latest Bank Credit Analyst (edited by Donald Storey), "A viable international system can only develop when some country can play banker to the rest of the world". This occurred with England during the half century prior to 1914. Following World War I the U.S. took over. Storey states that the following attributes are required to play the part of banker to the world: (1) A good reserve position, (2) A currency of unquestioned convertibility, (3) A healthy balance-of-payments position, and (4) The authority to make everyone play by the rules.

The U.S. has lost its position on all four counts and no other nation is in shape to take over. The IMF cannot possibly take over since no one trusts its liabilities nor will any nation "bow" to IMF edicts. This leaves the world without monetary leadership for the first time within the memory of any living man.

The U.S. was phenomenally lucky during 1971, because as the dollar weakened foreign governments purchased dollars in order to "prop" the dollar up against their own currencies. In other words, they did not want the situation to appear as if their own currencies were "too strong" against the sagging dollar. It has been estimated that as much as $30 billion were purchased for this reason during 1971, virtually taking the pressure off the Fed. to buy up the U.S. deficit. With the realignments of currencies, foreign governments will have no intention of taking in more dollars during 1972.

From the standpoint of the U.S. budget, even Newsweek (Jan. 8) asks, "Is the Budget Out of Control?" and suggests that the 1973 deficit could be $26 billion (I think it will be much , much bigger). This means more inflation and even less confidence in what is left of the U.S. dollar. On the balance-of-payments front, the recessions in Europe promise to hit U.S. exports while the rise in spending indicates rising imports. Both factors (despite monetary realignments) suggest to me that the U.S. trade balance is fated to stay in deficit during 1972 and perhaps surprisingly so.

And this brings us to the critical question. What happens as U.S. dollars continue to pile up overseas? What happens as foreign creditors (who are already stuck with mountains of dollars) realize that without convertibility, they will be robbed in 1972 in the same way as they were robbed in 1971 and '70 and '69 , etc.? According to Dr. Harry Schultz (Jan. 1 report) "Europe will demand dollar convertibility and decrease in capital investments abroad (i.e., buying up the world). The U.S. won't agree to those terms so monetary war is declared. The problems will find their sad solutions from the depths of a U.S. depression."

Actually, I believe that keen minds now realize that the entire monetary go-round of 1971 was meaningless without the establishment of a convertible currency. If the dollar was devalued to say 140 to an ounce of gold and the U.S. was to dig in and become respectable as a (financial) entity, then the system might continue with the U.S. playing banker. But the idea of the U.S. following sound economic policies (prior to a collapse) is totally remote.

That leaves the world in a strange position. The U.S. is still running budget deficits, the U.S. is probably going to run trade deficits, U.S. creditors are sitting with $60 billion. They want something tangible for it, and there is no dollar convertibility. Now, wiser minds know that convertibility must be established somewhere along the line, either through choice or through chaos and then necessity. When that time comes, it will not be based on a dollar devalued to only $38. It will have to be something more like 70 to 140 dollars per ounce of gold (or perhaps a European common currency based on a new high price for gold). Whatever is developed, it will be gold and gold at a high price.

That, very simply, is why I think informed interests are moving into gold now, and that is why the price of gold is on the march.

GOLD & SILVER: On January 17 gold continued its upward rush, moving over the $46 mark in London for the first time in history (see chart below). At the same time, spot silver went over $1.50, and some of the silver stocks I recently recommended (Letter 515) were on the move. Meanwhile, the dollar was hitting new lows on the overseas exchanges, where a few (such as Italy) were finding themselves in the unenviable position of again supporting the dollar against their own currencies. Historically, the strongest currency is a major currency which has just been devalued (since the realignments should have placed the currency in a strong position). The spectacle of the dollar going to new lows after realignments indicates that no one has faith in the dollar or wants it, even with other currencies re-valued against it! This is an unbelievable market verdict which says, "The dollar is so weak, U.S. inflation is so virulent, the U.S. trade position is so poor, that even after realignments of currencies the dollar is sinking." The monetary story has yet to be told. (Silver charts courtesy of Quote Digest, Box 213, Wichita, Kansas 67201).